

MEMORANDUM OF LAW

DATE: March 10, 1993

TO: D. Cruz Gonzalez, Risk Management Director

FROM: City Attorney

SUBJECT: Flexible Benefit Election Changes

Recently, one of the City's labor organizations has challenged the City's policy of not allowing election changes by employees after the cafeteria plan year has begun except pursuant to the specific provisions of Internal Revenue Service ("IRS") Regulation section 1-125-1, question and answer 8. Apparently, the Municipal Employees Association has determined that IRS Regulation section 1-125-2, question and answer 6 supersedes the above noted regulation and allows mid-year changes. You have asked if the MEA interpretation is correct. Based upon the provisions of the IRS Regulations, mid-year plan changes are permitted only in limited circumstances.

ANALYSIS

IRS Regulation section 1-125-2, question and answer 6 allows employees to change plan benefits in mid-year for six specific reasons. The following are acceptable reasons for allowing plan changes:

1. Significant cost or coverage changes - Cost changes. If the cost of a health plan provided by an independent, third-party provider under a cafeteria plan increases or decreases during a plan year and under the terms of the cafeteria plan, employees are required to make a corresponding change in their premium payments, the cafeteria plan may, on a reasonable and consistent basis, automatically increase or decrease, as the case may be, all affected participants' elective contributions or after-tax employee contributions for such health plan.

Alternatively, if the premium amount significantly increases, a cafeteria plan may permit participants either to make a corresponding change in their premium payments or to revoke their elections and, in lieu thereof, to receive on a prospective basis, coverage under another health plan with similar coverage. No elective adjustments of participants' contributions or revocations of participants' elections other than those provided for in the preceding sentence may be permitted under a cafeteria plan on account of changes in the cost of a health plan. (Emphasis added.)

2. Coverage changes. If the coverage under a health plan provided by an independent, third-party provider is significantly curtailed or ceases during a period of coverage, a cafeteria plan may permit all affected participants to revoke their elections of the health plan and, in lieu thereof, to receive on a prospective basis coverage under another health plan with similar coverage. (Emphasis added.)

3. Certain changes in family status. A cafeteria plan may permit a participant to revoke a benefit election during a period of coverage and to make a new election for the remaining portion of the period if the revocation and new election are both on account of a change in family status and are consistent with such change in family status. For purposes of this paragraph, examples of changes in family status for which a benefit election change may be permitted include the marriage or divorce of the employee, the death of the employee's spouse or a dependent,

the birth or adoption of a child of the employee, the termination of employment (or the commencement of employment) of the employee's spouse, the switching from part-time to full-time employment status or from full-time to part-time status by the employee or the employee's spouse, and the taking of an unpaid leave of absence by the employee or the employee's spouse.

4. Separation from service.

A cafeteria plan may permit an employee who separates from the service of the employer during a period of coverage to revoke existing benefit elections and terminate the receipt of benefits for the remaining portion of the coverage period.

5. Cessation of required contributions. A cafeteria plan may provide that a benefit will cease to be provided to an employee if the employee fails to make the required premium payments with respect to the benefit (e.g., employee ceases to make premium payments for health plan coverage after a separation from service). However, in such case, the plan must prohibit the employee from making a new benefit election for the remaining portion of the period of coverage.

6. Elective contributions under a qualified cash or deferred arrangement. A cafeteria plan may permit a participant who has elected to make elective contributions under a qualified cash or deferred arrangement (within the meaning of section 401(k)) to modify or revoke the election as permitted under section 401(k)). Similarly, a cafeteria plan may permit a participant who has elected to make

after-tax employee contributions subject to section 401(m) to modify or revoke the election as permitted under section 401(m). Thus, for example, a cafeteria plan may include a benefit option providing for elective contributions under a qualified cash or deferred arrangement which requires that, as a condition of a hardship distribution, the employee receiving the distribution cease making elective contributions under the arrangement for a specified period.

Note that the first two allowable changes contemplate plan-wide changes and although each individual member controls his or her own selection, the driving force behind change is a significant change in the benefits offered by the provider. No allowance is made for singular election changes under these sections.

The reasons stated in sections 3, 4, and 5 contemplate significant changes in the individual employee's family or employment status brought about by the employee's action or inaction. Again, these are permissible reasons for a change in elections. However, each change occurs only after a specific condition precedent. Finally, section 6 allows changes only pursuant to the provision of IRS sections 401(k) and 401(m). IRS sections 401(k) and 401(m) are not applicable to the situations you have described.

No changes in elections are allowed simply because an employee has made an election in error. The summary plan description is very clear that mid-year changes are not allowed in the City's flexible benefits cafeteria plan. It reads in pertinent part:

Federal law requires that once you have chosen your benefits and the Plan Year begins, they will stay in effect until the Plan Year ends. This includes the amount you contribute to your Retirement Accounts. However, if you have a change in family status that affects your benefit needs, you may be able to change your benefit selections before the end of the Plan Year.

The acceptable changes in family status are then listed specifically in the summary. The listing in the summary reflects the changes documented in IRS Regulation section 1-125-2, question and answer 6. Additionally, employees are required to watch the flexible benefits plan video and the video reiterates the plan summary statement concerning the permissible reasons for plan election changes. To allow changes for any but the enumerated IRS regulatory reasons would jeopardize the tax-qualified status of the City's cafeteria plan and should not be allowed.

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